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Technical Assistance Request

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You have asked us informally for assistance in connection with adjustments resulting from your examination of the federal income tax returns of [REDACTED] and its unconsolidated subsidiaries. At issue are the consequences of your disallowance of a deduction by [REDACTED] of premiums paid indirectly to a captive insurance subsidiary.

FACTS

[REDACTED], a domestic corporation that produces [REDACTED], owns all of the stock of [REDACTED], a reinsurance subsidiary organized in Bermuda in [REDACTED]. [REDACTED] is a participant in a pooled reinsurance arrangement incorporated as the [REDACTED], also a Bermuda corporation. During the taxable years at issue in this case, [REDACTED] and following, [REDACTED] had [REDACTED] participants other than [REDACTED], all of which were unrelated companies.

For the taxable years at issue in this case, [REDACTED] purchased workers' compensation, automotive, general and product liabilities insurance from [REDACTED], an unrelated domestic insurance company. [REDACTED] reinsured with [REDACTED] the first \$ [REDACTED] of risk assumed from [REDACTED]

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[REDACTED]

(after [REDACTED], this cap was increased to \$[REDACTED] for workers' compensation insurance). However, the premium income attributable to the reinsured risk was ceded to [REDACTED] only after [REDACTED] deducted certain amounts from the amounts it received from [REDACTED].¹ [REDACTED] retained risk over \$[REDACTED] (after [REDACTED], risk over \$[REDACTED] for workers' compensation insurance) and the portion of the insurance premiums from [REDACTED] that were attributable to the insurance of such risk.

The items deducted by [REDACTED] included amounts for [REDACTED] profit, producer commissions, state and federal taxes, claims handling charges, loss fund increases, and paid losses. Each of these items was an expense of [REDACTED] that was paid by [REDACTED]. For [REDACTED] of [REDACTED], for example, a worksheet listing the premiums [REDACTED] received and the amounts [REDACTED] deducted from the premiums ceded to [REDACTED] reflects that of \$[REDACTED] subject to cession by [REDACTED] to [REDACTED], \$[REDACTED] was the amount remaining after deducting the various [REDACTED] expenses described above.

[REDACTED] reinsured with [REDACTED] the first \$[REDACTED] of risk assumed from [REDACTED], and ceded to [REDACTED] the premium income attributable to the insurance of such risk. [REDACTED] simultaneously assumed from [REDACTED] the first \$[REDACTED] of [REDACTED]'s pooled risk, and received from [REDACTED] the premium income attributable to the insurance of such pooled risk. The premium income attributable to [REDACTED]'s risk ceded by [REDACTED] to [REDACTED] was roughly equivalent to the income attributable to the pooled risk ceded to [REDACTED] by [REDACTED].

Taxpayer represents that the pooling arrangement among [REDACTED]'s members is governed by three agreements: an overall operating agreement, under which [REDACTED] (a subsidiary of [REDACTED]) is appointed managing agent; a casualty retrocession agreement, under which [REDACTED] assumes risk of each of its members up to \$[REDACTED] per loss, for which [REDACTED] receives premium payments; and, a casualty loss agreement, under which the members agree to pay [REDACTED] a specified percentage of the losses paid by [REDACTED] with respect to the losses [REDACTED] reinsured. Each member is responsible for the percentage of losses equal to its percentage share of the premiums ceded to [REDACTED] under the

¹ The amount that is subject to cession by [REDACTED] to [REDACTED] for the risk reinsured with [REDACTED] will be referred to as the "gross amount ceded," and the amount actually ceded by [REDACTED] to [REDACTED] after deducting the various expense items will be referred to as the "net amount ceded."

casualty retrocession agreement, and receives premiums from [REDACTED] attributable to the risk it assumed.

DISCUSSION

The revenue agent's report denies [REDACTED] a deduction for the premiums paid to [REDACTED] to the extent [REDACTED] ceded such premiums to [REDACTED] to reinsure a portion of the risk it assumed. We have been asked to determine the tax consequences to [REDACTED] of treating the gross amount ceded by [REDACTED] as a contribution to the capital of [REDACTED] for which [REDACTED] is not allowed a deduction. This question has two parts: first, whether the earnings and profits of [REDACTED] must be reduced by the amount reported by [REDACTED] as premium income that has been recharacterized as a contribution to capital; and, second, whether the items [REDACTED] netted out of the gross amount ceded to [REDACTED] are deductible by [REDACTED] in calculating its taxable income and earnings and profits for purposes of subpart F.

[REDACTED] argues that if the gross amount ceded by [REDACTED] is treated as a payment to a captive insurer that is not deductible by [REDACTED], then the calculation of its income under subpart F of the Code must be adjusted to reflect that the earnings and profits of [REDACTED] must be reduced by the amount of [REDACTED] reported as premium income that has been recharacterized as a contribution to capital. In addition, taxpayer argues that its earnings and profits should also be reduced by the [REDACTED] expenses paid by [REDACTED] from the gross amount ceded by [REDACTED] to [REDACTED].

In general, a U.S. shareholder of a controlled foreign corporation (a "CFC") is required to include currently in its gross income certain items of income of the CFC (the CFC's "subpart F income"), determined pursuant to subpart F of the Code. A United States shareholder, defined in section 951(b), is a U.S. person that owns 10 percent or more of the combined voting power of all classes of stock of the foreign corporation that are entitled to vote. [REDACTED], which owns all of the stock of [REDACTED], is thus a U.S. shareholder of that corporation. A CFC is a foreign corporation more than 50 percent of the value or voting power of whose stock is owned by United States shareholders. See section 957. Since all of the stock of [REDACTED] is owned by [REDACTED], [REDACTED] is a CFC of [REDACTED] within the meaning of section 957.

Pursuant to section 952(a)(1), subpart F income includes insurance income, which is defined to include income attributable to the reinsurance or issuing of any insurance or

annuity contract in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, a country other than the country in which the controlled foreign corporation is organized. Such insurance income must also be income that would be taxable under subchapter L of chapter 1 of the Code if it were income of a domestic insurance corporation. See section 953(a)(1). The subpart F income of a CFC is limited, however, by the amount of the CFC's earnings and profits. Section 952(c)(1)(A).

reported the gross amount ceded by to as an amount paid for insurance that was deductible pursuant to section 162 of the Code. Consistent with this characterization, treated the gross amount ceded by as insurance income within the meaning of section 953. Thus, the insurance income was included in the calculation of 's taxable income and earnings and profits for purposes of subpart F.

Pursuant to Rev. Rul. 77-316, 1977-2 C.B. 53, however, the gross amount ceded to by which was reported by as premium income, has been recharacterized by the Service as a contribution to the capital of by ². It follows that because the gross amount ceded to by is not insurance income within the meaning of section 953 of the Code, such amount must be excluded from the calculation of the taxable income and earnings and profits of for purposes of subpart F.

² As noted above, was therefore denied a deduction for this amount. Thus, if paid insurance premiums to of \$150, \$100 of which was the gross amount ceded by to, then would be denied a deduction for \$100 of the \$150. The \$100 for which a deduction was denied would instead be characterized as a contribution to the capital of by.

It should be noted that was also denied a deduction for the amounts ceded by to under the reinsurance contracts between and. The pooling arrangement involving the members is under consideration in another district in connection with the examination of the returns of for its early-'s tax years. The various district offices that are examining the substance of the structure may thus wish to coordinate their examinations.

██████████ should be permitted to reduce its earnings and profits by the gross amount ceded by ██████████ even though ██████████ netted out certain items from the gross amount ceded to pay various expenses of ██████████. ██████████ reported the gross amount ceded by ██████████ as insurance income within the meaning of section 953, and such amount was recharacterized by the Service as a contribution to the capital of ██████████ by ██████████. In addition, ██████████ should be permitted to deduct the items of ██████████ expense that ██████████ netted out from the gross amount ceded to ██████████, but only to the extent that such items are deductible under the Code.

If ██████████ is allowed to deduct the items netted out of the gross amount ceded by ██████████, and to deduct the gross amount ceded, it has been argued that the items of deduction are counted twice in adjusting the earnings and profits of ██████████ to account for the recharacterization of its premium income as a contribution to capital. The double counting occurs when the earnings and profits are reduced first by the gross amount ceded, and then by the items of ██████████ expense netted out of the gross amount ceded by ██████████, since the items of ██████████ expense are paid out of the contribution to capital, and not gross income of ██████████. However, a deduction for an item cannot be disallowed simply because the payment of the item is made from capital rather than from income of a corporation. Otherwise, a corporation could never have a deficit in earnings and profits.

It has been assumed for purposes of the above discussion that the items of ██████████ expense netted out of the gross amount ceded by ██████████ are deductible items under the Code. However, ██████████ may deduct its items of expense only if the recharacterization of the premium income as a contribution to capital does not affect the treatment of its items of expense for U.S. tax purposes. A consequence of recharacterizing the gross amount ceded by ██████████ as a contribution to the capital of ██████████ may be that the activity of ██████████ that gives rise to the items of expense, for which a deduction is claimed, must also be recharacterized. For example, certain items of expense may depend on the characterization of the activity of ██████████ as insurance, pursuant to sections 801 through 847 of the Code. Because the payments by ██████████ giving rise to such expenses are no longer characterized as payments for insurance, it should be argued that a deduction for such items will be disallowed.

The deductibility of the items of ██████████ expense should be determined item by item - the ██████████ profit netted out from the gross amount ceded; producer commissions; state and federal

insurance taxes; claims handling charges; loss fund reserve increases; and, paid losses. For example, [REDACTED] may deduct the excise taxes paid pursuant to section 4371 of the Code if the payment of the tax is treated as an ordinary and necessary expense pursuant to section 162. See section 1.164-2(f) of the Income Tax Regulations. Items such as [REDACTED] profit, producer commissions, claims handling charges, losses paid, and state and federal insurance taxes could be deductible. As a corporation, [REDACTED] is likely to be treated as engaged in a trade or business, and the above expenses are imposed in connection with its business activity. See GCM 37071; Campbell Taggart, Inc. v. U.S., 744 F. 2d 442, 452-53 (5th Cir. 1984). However, because the gross amount ceded to [REDACTED] is not insurance income (i.e. because its business activity is not insurance), [REDACTED] should not be entitled to the benefits of the insurance tax provisions of subchapter L of the Code. Thus, [REDACTED] should not be allowed to deduct its loss fund reserve increases. See section 832(b)(5)(A).

If you have any questions or comments, please call me or Jim Sams at 566-6645.

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